

2014 Basics of Basis



National Association
of Tax Professionals

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Course Description

When buying or selling assets, the basis of those items is critical to the future calculation of capital recovery, gain or loss realization and recognition, and depreciation. This course provides the tools to determine an asset's initial basis and adjustments to that basis. Assets discussed are tangible or intangible property, including; real and personal property, stocks, bonds, and mutual funds, as well as partnership and S corporation interests.

Objectives

Upon completion of this course, you will be able to:

- Identify basis based on various means of acquisition including purchase, creation, gift and inheritance.
- Identify adjustments to basis.
- Identify payments that need to be capitalized as part of basis and those that can be expensed as a current operating expense.
- Calculate the basis of a bond when it is purchased or sold before its maturity date.
- Calculate the basis of stocks.
- Identify wash sales.
- Calculate the basis of mutual funds using the allowable methods.
- Calculate original basis for partners and shareholders.
- Apply the timing and ordering of basis adjustments.
- Differentiate between outside and inside basis in a partnership.
- Recognize the differences between stock basis and debt basis in an S corporation.
- Recognize how debt in a partnership or S corporation impacts basis.

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SAMPLE

What is Basis

What is basis and why do we need it?

Basis is the cost of an asset plus sales tax and other expenses incurred to purchase or to place the asset in service for tax purposes. To a tax professional basis is the foundation for calculating depreciation, amortization, depletion, casualty losses, and the gain or loss on the sale or exchange of the asset.

Once the initial basis is determined it is increased or decreased for various items. This results in adjusted basis. In general, adjusted basis is initial basis increased by items such as capital improvements and decreased by capital recoveries such as depreciation, amortization, casualty and theft losses and certain tax credits. Taxpayers are entitled to recover the initial basis of property and are not taxed on it upon disposition.

Under §1001(a), *Computation of gain or loss*, realized gain is the amount received in a disposition that exceeds the adjusted basis. Recognized gain is the amount of realized gain included in the taxpayer's income. Loss is the excess of the adjusted basis over the amount received.

It is the taxpayer's responsibility to keep accurate records to prove basis. These records must be kept as long as the taxpayer owns the property. Without proof to support basis, the IRS can assign a value to the property, such as zero.

Cost Basis

Taxpayers purchase assets for their businesses, however they are not allowed to deduct the entire cost of the purchase immediately. Cost is deducted over time as depreciation, depletion or amortization. Basis is used to calculate the annual deduction. In addition to business assets, taxpayers purchase stocks and bonds for investment purposes. Basis is used to calculate the proper gain or loss when the investment is sold.

As a general rule the cost to acquire or to produce property is the measure of invested capital. Cost includes the amount of cash paid or other resources such as debt obligations, other property, or services, without consideration for additional expenditures, credits or refunds.

Purchased Property

The basis of property purchased is generally its cost (§1012) which includes the following.

- Cash paid.
- Loan proceeds used to acquire the property.
- Other property or services provided.
- Sales tax.
- Freight.
- Installation and testing costs.
- Excise tax.
- Legal and accounting fees.
- Recording fees.
- Real estate taxes paid for the seller.

Some purchases may include both capital expenditures and current expenses. For example, a company could purchase a new laser printer and additional toner cartridge in one transaction. The laser printer would be capitalized, however the toner cartridge would be a current expense, expensed to office supplies. The cost of the transaction is allocated between the two items.

Additionally, a single purchase could be for multiple assets. For example, a company could purchase several computers and printers in one transaction. To properly track basis for depreciation and calculate gain or loss on disposal, the payment must be allocated between the separate assets.

Real Property

The basis in real property, or real estate, is generally the purchase price or construction cost, plus any costs to acquire the property, such as:

- Cost of the land.
- Cost of labor and materials.
- Architect's fees.
- Building permits.
- Payments to contractors.
- Payments for rental equipment.
- Inspection fees.
- Settlement costs.
- Closing costs.
- Real estate taxes.

NOTE: If the buyer pays the delinquent real estate taxes of the seller and is not reimbursed by the seller, the amount paid is added to the buyer's basis of the property. If the buyer reimburses the seller for real estate taxes in the year the property is acquired, the amount paid is generally deductible by the buyer as a current year expense. If the buyer does not reimburse the seller for the real estate taxes in the year of sale, the purchase price is reduced by this amount [Reg. §1.164-6].

Settlement fees and closing costs are amounts incurred to purchase property and obtain funding. A fee for purchasing property is any cost that must be paid even if the property was purchased for cash. Certain fees and costs incurred for purchasing the property are capitalized, or added to basis, while fees and costs incurred to obtain funding are not.

Fees and costs for purchasing property and obtaining funding are detailed on the 12 part Settlement Statement (HUD-1) form, often simply called the HUD Statement, Closing Statement or Settlement Statement.

Settlement and closing costs that **can** be added to basis include the following.

- Abstract fees.
- Charges for installing utilities.
- Legal fees for services, such as:
 - Title search.
 - Preparation of the sales contract.

- Preparation of the deed.
- Recording fees.
- Surveys.
- Transfer taxes.
- Owner's title insurance.
- Any amounts that the buyer agrees to pay for the seller, such as:
 - Back taxes.
 - Interest.
 - Recording fees.
 - Mortgage fees.
 - Charges for improvements and repairs.
 - Sales commission.

Settlement costs and closing fees that **cannot** be added to basis include the following.

- Insurance premiums.
- Rent for occupancy of the property before the closing.
- Charges for utilities or other services related to occupancy prior to the closing.
- Charges and fees related to acquiring a loan, such as:
 - Points and loan origination fees.
 - Mortgage insurance premiums.
 - Loan assumption fees.
 - Cost of credit reports.
 - Fees for an appraisal required by the lender.
 - Fees for refinancing a mortgage.

Settlement costs do not include any amounts placed in an escrow account to be used to pay future items such as real estate taxes and property insurance.

For business acquisitions, expenses such as insurance, rent, and utilities or other service charges before closing can be deducted as ordinary and necessary business expenses. Charges and fees for acquiring the loan must be capitalized and can be amortized over the life of the loan. However, if this is not business property, the taxpayer simply incurs these costs as part of the purchase.

Points, also known as discount points, are a form of prepaid interest. One point is usually equal to 1% of the loan amount. Points are paid either by the purchaser or seller when a mortgage is obtained to purchase a main home. Generally, the purchaser can deduct the points in full as an itemized deduction in the year they are paid. However, the purchaser's basis is reduced by any seller-paid points or loan origination fees.

Any points incurred to acquire a mortgage on a second home, second mortgage, line of credit, or a home equity loan, are amortized over the life of the loan and are not fully expensed in the year paid.

Example On April 15, Jack and Jill Hill purchased a rental property from Dick and Jane Spot for \$200,000. The settlement statement (HUD-1) provided the following information.

The basis for the buyer and seller are as follows.

<u>Description</u>	<u>Buyer</u>	<u>Seller</u>
Initial selling price	\$200,000	\$200,000
Settlement charges	500	0
Settlement closing fees	0	200
State tax/stamps	0	1,500
Commission and fees	<u>0</u>	<u>12,200</u>
Total basis	\$200,500	\$213,900

The Hill's use \$200,500 as their basis and the Spot's use \$200,000 as the selling price and \$13,900 as cost of sale. The property tax allocation is deductible by the Spot's on their Schedule A, *Itemized Deductions*, or Schedule E, *Supplemental Income and Loss*, while the Hill's property tax deduction on Schedule E is reduced by this amount. The costs of the appraisal fee and the flood certification were necessary to acquire the loan and therefore are not part of the basis. Because this is a rental property, the Hill's capitalize the costs of obtaining the loan and amortize them over the life of the loan on Schedule E.

For depreciation purposes the Hill's allocate the \$200,500 between land and building. The numerator is the FMV of either the building or the land individually and the denominator is the FMV of the entire property. If there are no documents stating specifically what the FMV of the building and land are, often a percentage is determined by using the assessed value of the land and the land improvement to the total assessed value of the property on the real estate tax bill.

Example continued

J. Summary of Borrower's Transaction				K. Summary of Seller's Transaction			
100. Gross Amount Due from Borrower				400. Gross Amount Due to Seller			
101. Contract sales price			\$200,000.00	401. Contract sales price			\$200,000.00
102. Personal property				402. Personal property			
103. Settlement charges to borrower (line 1400)			\$500.00	403.			
104.				404.			
105.				405.			
Adjustment for items paid by seller in advance				Adjustment for items paid by seller in advance			
106. City/town taxes	to			406. City/town taxes	to		
107. County taxes	to			407. County taxes	to		
108. Assessments	to			408. Assessments	to		
109.				409.			
110.				410.			
111.				411.			
112.				412.			
120. Gross Amount Due from Borrower			\$200,500.00	420. Gross Amount Due to Seller			\$200,000.00
200. Amount Paid by or in Behalf of Borrower				500. Reductions in Amount Due to seller			
201. Deposit or earned money			\$10,000.00	501. Excess deposit (see instructions)			
202. Principal amount of new loan(s)			\$150,000.00	502. Settlement charges to seller (line 1400)			\$13,900.00
203. Existing loan(s) taken subject to				503. Existing loan(s) taken subject to			
204.				504. Payoff of first mortgage loan			\$100,000.00
205.				505. Payoff of second mortgage loan			
206.				506.			
207.				507.			
208.				508.			
209.				509.			
Adjustments for items unpaid by seller				Adjustments for items unpaid by seller			
210. City/town taxes	to			510. City/town taxes	to		
211. County taxes	01/01/12 to 04/15/12		\$500.00	511. County taxes	01/01/12 to 04/15/12		\$500.00
212. Assessments	to			512. Assessments	to		
213.				513.			
214.				514.			
215.				515.			
216.				516.			
217.				517.			
218.				518.			
219.				519.			
220. Total Paid by/for Borrower			\$160,500.00	520. Total Reduction Amount Due Seller			\$114,400.00
300. Cash at Settlement from/to Borrower				600. Cash at Settlement to/from Seller			
301. Gross amount due from borrower (line 120)			\$200,500.00	601. Gross amount due to seller (line 420)			\$200,000.00
302. Less amounts paid by/for borrower (line 220)			(\$160,500.00)	602. Less reductions in amounts due seller (line 520)			(\$114,400.00)
303. Cash <input checked="" type="checkbox"/> From <input type="checkbox"/> To Borrower			\$40,000.00	603. Cash <input checked="" type="checkbox"/> To <input type="checkbox"/> From Seller			\$85,600.00

The Public Reporting Burden for this collection of information is estimated to average 35 minutes per response for collecting, reviewing, and reporting the data. This agency may not collect this information, and you are not required to complete this form, unless it displays a currently valid OMB control number. No confidentiality is assured; this disclosure is mandatory. This is designed to provide the parties to a RESPA covered transaction with information during the settlement process.

Example continued

L. Settlement Charges					
700. Total Real Estate Broker Fees					
Division of commission (line 700) as follows:					
701. \$	to			Paid From Borrower's Funds at Settlement	Paid From Seller's Funds at Settlement
702. \$	to				
703. Commission paid at settlement					\$12,000.00
704. Processing Fee					\$200.00
800. Items Payable in Connection with Loan					
801. Our origination charge	\$		(from GFE #1)		
802. Your credit or charge (points) for the specific interest rate chosen	\$		(from GFE #2)		
803. Your adjusted origination charges			(from GFE #A)		
804. Appraisal fee to			(from GFE #3)	\$300.00	
805. Credit report to			(from GFE #3)		
806. Tax service to			(from GFE #3)		
807. Flood certification to			(from GFE #3)	\$50.00	
808.					
809.					
810.					
811.					
900. Items Required by Lender to be Paid in Advance					
901. Daily interest charges from	to	@ \$	day	(from GFE #10)	
902. Mortgage insurance premium for	months to			(from GFE #3)	
903. Homeowner's insurance for	years to			(from GFE #11)	
904.					
1000. Reserves Deposited with Lender					
1001. Initial deposit for your escrow account				(from GFE #6)	
1002. Homeowner's insurance	months @ \$		per month \$		
1003. Mortgage insurance	months @ \$		per month \$		
1004. Property Taxes	months @ \$		per month \$		
1005.	months @ \$		per month \$		
1006.	months @ \$		per month \$		
1007. Aggregate Adjustment					-\$
1100. Title Charges					
1101. Title services and lender's title insurance				(from GFE #4)	
1102. Settlement or closing fee				\$	\$200.00
1103. Owner's title insurance				(from GFE #5)	
1104. Lender's title insurance				\$	
1105. Lender's title policy limit \$					
1106. Owner's title policy limit \$					
1107. Agent's portion of the total title insurance premium to				\$	
1108. Underwriter's portion of the total title insurance premium to				\$	
1109.					
1110.					
1111.					
1200. Government Recording and Transfer Charges					
1201. Government recording charges				(from GFE #7)	\$50.00
1202. Deed \$	Mortgage \$		Release \$		
1203. Transfer taxes				(from GFE #8)	
1204. City/County tax/stamps	Deed \$		Mortgage \$		
1205. State tax/stamps	Deed \$		Mortgage \$		\$1,500.00
1206.					
1300. Additional Settlement Charges					
1301. Required services that you can shop for				(from GFE #6)	
1302. Survey		\$			\$100.00
1303.		\$			
1304.					
1305.					
1400. Total Settlement Charges (enter on lines 103, Section J and 502, Section K)				\$500.00	\$13,900.00

Environmental Cleanup Costs

Whether environmental cleanup costs are added to basis or expensed when incurred or paid depends on the circumstances.

Environmental cleanup costs are subject to the restoration principle. This simply means that if the land was not contaminated when it was acquired and became contaminated during the normal course of business use, then the costs incurred or paid for cleanup can be expensed as current operating expenses under §162.

The restoration principle applies when the following three conditions are met.

- The property is contaminated in the ordinary course of business.
- The property is restored to its pre-contaminated state.
- The cleanup did not allow the property to be put to a new use.

However, if the land was contaminated when it was acquired, any costs incurred or paid for cleanup that result in a permanent improvement increasing the value of the property, prolonging its useful life, or adapting it to a new or different use must be capitalized or added to basis under §263A.

The key is if the cleanup costs increase the property's value then they must be added to basis, if not then they can be expensed (Rev. Rul. 94-38).

NOTE: In Rev. Rul. 2004-18, IRS instructs that when land is contaminated with hazardous waste by the operation of the taxpayer's manufacturing plant, the environmental remediation costs are subject to §263A and as such, costs incurred to clean up must be included in the inventory costs.

Expenses paid or incurred for the abatement or control of hazardous substances (including petroleum products) at a qualified contaminated site are called **qualified environmental remediation (QER)** expenses. Between August 5, 1997, and December 31, 2011, taxpayers could elect to deduct as current expenses any costs that would normally have been capitalized (§198).

Demolition Costs

Demolition costs and losses sustained due to demolition are added to the basis of the land the building is located on (§280B). Any remaining adjusted basis of the demolished building is also added to the basis of the land.

Under a safe harbor provision, a building modification is not treated as a demolition, but is instead added to the basis of the building if both of the following apply.

- 75% or more of the existing external walls of the building are retained in place as internal or external walls.
- 75% or more of the existing internal structural framework of the building is retained in place (Rev. Proc. 95-27).

If the building is a certified historic structure, the modification must also be part of a certified rehabilitation.

Section 280B does not apply to amounts elected to be expensed under the QER election [(§198(f))].

Certified Historic Structure

A certified historic structure is any property that meets the following.

- Building, structure, or land area listed in the National Register.
- Building in a registered historic district and certified by the Secretary of the Interior as being of historic significance to that district.

Improvements made to certified historic structures may qualify for a rehabilitation credit (§47) if the expenditures are qualified rehabilitation expenditures (QREs). QREs are any amounts chargeable to capital and incurred in the rehabilitation of a qualified rehabilitated building that is depreciable and is nonresidential real property, residential property if a certified historic structure, real property with a class life of more than 12.5 years, or an addition or improvement to any of the above.

Basis must be reduce by 100% of the credit claimed.

Subdivided Lots

The general rule of thumb is if there is a vacant piece of land, develop it. Consequently, tax preparers must know how to properly account for the costs developers incur in developing and subdividing land.

In general, basis must be calculated for each lot in a tract of land that was purchased as a whole and subdivided. Total costs allocated to the lots include the purchase price and common area improvement costs (not recoverable through depreciation) such as water lines, utilities, roads, greenbelts, parks, and other recreation facilities incurred to prepare the land for development.

If the developer sells the lots before the common area improvements are complete, Rev. Proc. 92-29 allows for an alternative cost method, with IRS consent, for actual costs plus estimated future costs of common area improvements for the next 10 years to be allocated to the lots for the calculation of the gain or loss on the disposal or sale of the lots. However, the total amount allocated to the sold properties may never be more than the actual cost incurred.

Example A developer is building 10 homes of equal value on a tract of land. The developer estimates common improvements will total \$500,000. Each home's allocable share of the estimated cost is \$50,000.

In year-1, four homes are sold and actual common costs incurred during the year equal \$250,000. The common costs allocated to each of the four homes is \$200,000 (\$50,000 x 4).

In year-2, four more homes are sold and actual common costs incurred are only \$30,000. The common costs allocated to each of the four homes in year-2 is \$80,000 instead of \$200,000 because the actual common costs are only \$280,000 (\$250,000 year-1 + \$30,000 year-2) instead of \$500,000 as originally projected. In year-1 \$200,000 of the costs were allocated to the homes sold, so in year-2 the remaining \$80,000 or \$20,000 each is allocated to the four homes sold.

In year-2 if the common costs had been \$150,000 or more, the entire \$50,000 estimated cost per home would have been allocated.

In year-3 when the remaining two homes are sold and the balance of the common costs incurred is \$220,000, each home is allocated \$110,000 of common costs (Rev. Proc. 92-29).

Any costs incurred specifically for a lot should be allocated only to that lot instead of allocating these costs to other lots. For example, a potential buyer may want a well or an entrance road added to the lot before purchase. Those costs specifically identified with that lot should be directly allocated to that lot.

Lot basis allocation can be made using any of the following.

- The percentage of FMV of the individual lots over the FMV of the entire tract of land.
- Appraised value.
- Assessed value based on real estate taxes.
- Square footage.
- Gross profit (costs allocated on a predetermined gross profit or gross margin percentage).

Loans to Acquire Property

Often taxpayers assume a mortgage as part of the agreement to purchase property. The amount of the mortgage assumed is included in determining the basis in the property. For example, a building is purchased for \$50,000 with a loan being assumed for \$50,000, the basis of the asset to the buyer is \$100,000 (\$50,000 cash plus \$50,000 assumed loan).

When a taxpayer purchases property with a loan or time-payment plan an appropriate rate of interest must be charged unless one of the following exceptions apply [Reg. §1.483-1(c)].

- Sales price is \$3,000 or less.
- Property transfers between spouses due to divorce.
- Sale or exchange of personal use property evidenced by a below-market loan.
- Demand loans evidenced as a below-market loan.
- Annuity contracts.

In accordance with Reg. §1.483-1(a)(2), the taxpayer does not include the unstated interest in the basis of the property acquired. If the loan has no interest rate or the rate is not adequate, a portion of each payment must be treated as interest.

NOTE: The minimum rate of interest required is the same as a test rate that is applicable at the time of the purchase. The test rate is the lowest three-month federal rate, which is the lowest applicable federal rate (AFR) in effect for any month in a three-month period ending with either the first month in which the written contract is consummated or the month in which the sale or exchange actually occurs. In accordance with §483(b), the total amount of the unstated interest is the amount by which the sum of the deferred payments exceeds the sum of the present values of the deferred payments and the present values of any stated interest payments due under the contract.

Cost Segregation

For income tax purposes, a cost segregation study involves the allocation (or reallocation) of the total cost (or value) of property into the appropriate property classes in order to compute depreciation. Generally, depreciation deductions are accelerated by separating personal property from real property, allowing cost recovery over fewer years.

Costs segregation studies are generally done before the property is purchased and the included in the agreement's cost allocation section. Segregation studies can be cost prohibitive so often only larger companies perform them.

NOTE: Cost segregation does not include a simple percentage allocation such as 10% of the purchase price.

The IRS uses the Cost Segregation Audit Techniques Guide when reviewing the basis of assets determined via a cost segregation study.

In addition to the audit guide, the IRS (CCA 199921045) provides guidelines in determining what qualifies as personal property and what qualifies as real property. These guidelines are as follows.

- Can the property be moved without significant alterations to the building structure? If yes – the property is personal, not real.
- Is the property designed to be moved or to stay in one place? Personal property is movable and real property is meant to stay in one place.
- Do circumstances exist to show that the property may need to be moved?
- How difficult would it be to move the property?
- How much damage would be caused if removed?
- Is this property attached to the land?

Business Purchase

When a taxpayer acquires a business or simply multiple assets for a lump sum, both the buyer and the seller can agree to a specific allocation of the purchase price among the assets acquired. When a buyer and seller enter into a written agreement that specifies the allocation of the purchase price or FMV, the agreement is binding on both parties unless the IRS determines that the amounts are not appropriate, which rarely occurs. The value allocated to each asset is based on the FMV of the asset [Reg. §1.1060-1(c)(4)].

When a buyer and seller cannot agree to a specific allocation, the purchase price is allocated to all assets using the residual allocation method. Under §1060(a), the assets transferred are divided into seven asset classes and the purchase price is allocated dollar for dollar to Class I and any remaining amount is allocated to each succeeding asset class in ascending order to the extent of their FMV. Any unallocated amounts remaining after Classes 1 through VI are allocated to Class VII, goodwill and similar assets.

- Class I assets are cash and general deposit accounts (including savings and checking accounts) other than certificates of deposit held in banks, savings and loan associations and other depository institutions.
- Class II assets are certificate of deposits, U.S. government securities, foreign currency and actively traded securities.
- Class III assets are accounts receivable, any debt instruments and property which mark-to-market has been used at least annually.
- Class IV assets are inventory and any other property held primarily for sale to a customer in the ordinary course of operating a trade or business.
- Class V assets includes all other property received other than §197 intangibles, goodwill and going concern.
- Class VI assets are §197 intangibles, except goodwill and going concern.
- Class VII assets are goodwill and going concern, whether or not they qualify as §197 intangibles.

Both the buyer and seller involved in the sale of business property must report the allocation of the purchase price to the IRS in the year of the sale by filing and attaching a Form 8594, *Asset Acquisition Statement Under Section 1060*, to their respective returns.

Example Bill sold Bob all the assets in his proprietorship business for \$325,000. The assets Bill sold have the following FMV.

Cash (Class I)	\$ 1,000
Accounts receivable (Class III)	25,000
Inventory (Class IV)	25,000
Land (Class V)	30,000
Building (Class V)	195,000
Equipment (Class V)	25,000
Covenant not to compete (Class VI)	15,000
Goodwill (Class VII)	<u>9,000</u>
Total	\$325,000

Bill and Bob agreed to this allocation and it was written into the purchase agreement. Form 8594 is as follows.

2 Date of sale	3 Total sales price (consideration) \$325,000
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Part II Original Statement of Assets Transferred			
4 Assets	Aggregate fair market value (actual amount for Class I)	Allocation of sales price	
Class I	\$ 1,000	\$	1,000
Class II	\$	\$	
Class III	25,000	\$	25,000
Class IV	25,000	\$	25,000
Class V	250,000	\$	250,000
Class VI and VII	24,000	\$	24,000
Total	\$ 325,000	\$	325,000

5 Did the purchaser and seller provide for an allocation of the sales price in the sales contract or in another written document signed by both parties? Yes No

If "Yes," are the aggregate fair market values (FMV) listed for each of asset Classes I, II, III, IV, V, VI, and VII the amounts agreed upon in your sales contract or in a separate written document? Yes No

6 In the purchase of the group of assets (or stock), did the purchaser also purchase a license or a covenant not to compete, or enter into a lease agreement, employment contract, management contract, or similar arrangement with the seller (or managers, directors, owners, or employees of the seller)? Yes No

If "Yes," attach a statement that specifies **(a)** the type of agreement and **(b)** the maximum amount of consideration (not including interest) paid or to be paid under the agreement. See instructions.

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Example Presume the same facts as prior example except the purchase price is \$275,000 with no covenant not to compete or goodwill.

The FMV of the tangible business assets is \$301,000. The purchase price is first allocated to cash of \$1,000, accounts receivable of \$25,000, and inventory of \$25,000. The remaining \$224,000 is allocated to Class V assets. There is no value allocated to Class VI or VII in this scenario. The \$224,000 is allocated between Class V assets based on their FMV.

Land	\$26,880	(\$30,000/\$250,000 x \$224,000)
Building	\$174,720	(\$195,000/\$250,000 x 224,000)
Equipment	\$22,400	(\$25,000/\$250,000 x \$224,000)

Form 8594 is as follows:

2 Date of sale		3 Total sales price (consideration) \$275,000	
Part II Original Statement of Assets Transferred			
4 Assets	Aggregate fair market value (actual amount for Class I)	Allocation of sales price	
Class I	\$ 1,000	\$	1,000
Class II	\$	\$	
Class III	\$ 25,000	\$	25,000
Class IV	\$ 25,000	\$	25,000
Class V	\$ 224,000	\$	224,000
Class VI and VII	\$	\$	
Total	\$ 275,000	\$	275,000

5 Did the purchaser and seller provide for an allocation of the sales price in the sales contract or in another written document signed by both parties? Yes No

If "Yes," are the aggregate fair market values (FMV) listed for each of asset Classes I, II, III, IV, V, VI, and VII the amounts agreed upon in your sales contract or in a separate written document? Yes No

6 In the purchase of the group of assets (or stock), did the purchaser also purchase a license or a covenant not to compete, or enter into a lease agreement, employment contract, management contract, or similar arrangement with the seller (or managers, directors, owners, or employees of the seller)? Yes No

If "Yes," attach a statement that specifies (a) the type of agreement and (b) the maximum amount of consideration (not including interest) paid or to be paid under the agreement. See instructions.

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 63769Z Form **8594** (Rev. 12-2013)

Asset Development

Asset Production

Basis of produced assets includes both direct and indirect costs. Cash paid and other costs incurred to bring an asset to a finished useable state are direct costs included in the basis of the asset. For tax purposes, other indirect costs are also included in the basis of an asset. The costs are added in accordance with the uniform capitalization rules of §263A.

Uniform Capitalization Rules

The uniform capitalization (UNICAP) rules specify that the cost of certain items are added to basis depending on circumstances [Reg. §1.263A-1].

UNICAP rules must be used if any of the following apply to the taxpayer's trade or business which is carried on for profit.

- Produce real or tangible personal property for use in the business or activity.
- Produce real or tangible personal property for sale to customers.
- Acquire property for resale. However, this rule does not apply to personal property if the company's average annual gross receipts for the previous three tax years were \$10 million or less.

A taxpayer is considered to produce property if they construct, build, install, manufacture, develop, improve, create, raise or grow the property. If property is produced for an entity under contract, treat it as produced by the taxpayer's company up to the amount paid or incurred.

The UNICAP rules define tangible personal property without regard to whether such property is treated as tangible or intangible property under other sections of the Internal Revenue Code. Thus, tangible personal property includes films, sound recordings, videotapes, books or similar property even though these assets are considered intangible for other purposes.

Under these rules, the taxpayer must capitalize all direct costs and an allocable part of most indirect costs incurred in the production or resale activities. Any cost not included in the calculation of taxable income, such as the 50% nondeductible meals, is not subject to the uniform capitalization rules.

The following are exceptions to the UNICAP rules.

- Property the taxpayer produces for personal use that is not used in a trade, business or activity conducted for profit.
- Qualified creative expenses the taxpayer pays or incurs as a freelance writer, photographer or artist, which are otherwise deductible.
- Property the taxpayer produces under a long-term contract, except for certain home construction contracts.
- Research and experimental expenses allowable as a deduction under §174.
- Intangible drilling and development costs allowed as a deduction under §59(e).

For other exceptions to the uniform capitalization rules, see Reg. §1.263A-1(b). There are special rules that apply to the costs incurred in the business of farming which are beyond the scope of this course and should be further researched for a farming business.

Asset Construction

The basis of an asset constructed by the taxpayer or constructed on behalf of the taxpayer includes the following items:

- Land.
- Labor and materials.
- Architect fees.
- Building permits.
- Contractor payments.
- Equipment rental payments.
- Inspection fees.

In addition, the use of business resources, such as employees, material and/or equipment, used to construct an asset requires the following costs to be capitalized into the basis of that asset.

- Employee wages paid for the construction work.
- Depreciation on the equipment the taxpayer owns while used in the construction.
- Operating and maintenance costs for equipment used in the construction.
- Costs of business supplies and materials used in the construction.

The basis of a constructed asset is reduced by the following credits allowed on wages paid for the construction of the asset.

- Work opportunity credit.
- Indian employment credit.
- Empowerment zone employment credit.

- Differential wage payment credit.
- New hire retention credit.

Labor costs for the business owner and labor costs not paid for are not included in the basis of the asset.

Intangible Assets

Intangible property includes goodwill, customer-based intangibles, market-based intangibles, assembled work force, order backlog, contract rights, noncompetition agreements, trademarks or trade names, patents and copyrights.

Intangible assets are either purchased or developed. The cost basis of a purchased intangible is determined by the general rule or as part of the cost allocation determined by the purchase of a business [Reg. §1.197-2(e)].

The costs of developing intangibles having a useful life of more than one year, such as trademarks, franchises, copyrights and patents are generally required to be capitalized to form the cost basis of the intangibles [Reg. §1.197-2(d)(2)(iii)].

The basis of a patent for an invention includes the following costs.

- Research costs.
- Experimental expenditures.
- Drawings.
- Working models.
- Attorney fees.
- Governmental fees.

The value of the inventor's time spent on the invention is not part of the basis.

Research and experimental expenditures incurred in connection with a trade or business may be expensed as a current business expense instead of capitalized as part of basis and amortized [§174(a)].

If the taxpayer is an author, the basis of the copyright usually includes:

- Costs of obtaining the copyright.
- Copyright fees.
- Attorney fees.
- Clerical assistance.
- Cost of plates that remain in the taxpayer's possession.

The value of the taxpayer's time as the author, or any other person's time that the taxpayer did not pay for, is not included in the basis of the copyright.

The basis of a franchise, trademark or trade name that was purchased is the amount paid or cost, less any amount that can be deducted as current year business expenses.

Self-created intangibles such as goodwill and customer lists do not have a cost basis [Reg. §1.197-2(d)(2)(i)] to the taxpayer who creates them. When the original owner sells the entity, part of the selling price to the new owner includes these amounts. The new owner is able to record and amortize them.

The cost of most acquired intangible assets, including goodwill and going concern value, are amortized ratably over a 15-year or 180 month period.

Basis Other Than Cost

There are times when cost of an asset cannot be used as basis. For these exceptions, use the FMV or the current adjusted basis of property to establish the taxpayer's basis. Some of the more common exceptions are:

- Substituted basis property — property considered either transferred basis property or exchanged basis property.
 - Gift is transferred basis property (§1015).
 - Like-kind exchange is exchange basis property (§1031).
- Involuntary conversions (§1033).
- Inherited property (§1014).
- Property received for services.
- Bargain purchases.
- Restricted property.

NOTE: For assets a taxpayer held on January 1, 2001, an election was available to treat the assets as sold at FMV and then reacquired on January 1, 2001. If this election was made, the taxpayer's basis in the asset is the FMV on the date the taxpayer reacquired the asset.

Gift

Generally, the basis of a gift is the donor's basis in the property plus all or a portion of any gift taxes paid on the transfer of the gift [Reg. §1.1015-5]. However, to determine the proper basis of the gift for the calculation of gain or loss on its sale, the recipient needs the donor's basis, the FMV of the asset when received, and any gift taxes paid on the transfer. If the FMV of the gift is less than the donor's basis, the actual basis of the gift is determined when the asset is sold.

Example Mona gave a self-portrait painting to her granddaughter. At the time she had the painting done, Mona's cost was \$10 and no gift tax was paid when she transferred the painting to her granddaughter. After Mona's death, her granddaughter sold the painting to a local art dealer for \$1,000,000. The granddaughter's basis in the painting is \$10.

When the FMV of the gifted property is less than the donor's adjusted basis, the recipient's basis depends on whether there is a gain or loss on the sale of the property.

- For computing a gain, the recipient's basis is the same as the donor's adjusted basis plus or minus any basis adjustments required by the recipient.
- For computing a loss, the recipient's basis is the FMV when the gift was received plus or minus any basis adjustment required by the recipient.

Example A grandmother gives her granddaughter an acre of land with a FMV of \$9,000 and an adjusted basis of \$10,000 on the date of the gift. If the granddaughter has no adjustments that are necessary and subsequently sells the land for \$15,000 she has a gain of \$5,000 since she must use her grandmother's basis. However, if the granddaughter sells the land for \$8,000 instead she has a loss of \$1,000 since she must use the FMV of the land at the time of the gift or \$9,000 as the basis.

If the gifted property is used in business, the basis for calculating depreciation, depletion or amortization is the same as the donor's adjusted basis plus or minus any adjustments the recipient is required to make.

For gifts made after December 31, 1976, basis is increased by the portion of the gift tax attributable to the amount by which the FMV of the gift exceeds the donor's adjusted basis immediately prior to the gift, or the net appreciation in the value of the gift [§1015(d)(6)(B)].

Example Prior to 2014, George exhausts his gift tax applicable credit. In 2014, George makes a gift to his son of a parcel of real estate having a FMV of \$104,000. George's adjusted basis in the real estate immediately before making the gift was \$71,000. Also during the year, George makes a gift to his daughter of a painting having a FMV of \$74,000. George timely files a gift tax return for the current year and pays the amount of \$38,800 computed as follows.

Value of real estate transferred to son	\$104,000	
Less: Annual Exclusion	<u>14,000</u>	90,000
Value of painting transferred to daughter	\$ 74,000	
Less: Annual Exclusion	<u>14,000</u>	<u>60,000</u>
Total included gifts		\$150,000
Total gift tax liability for 2014 gifts		\$ 38,800

The gift tax paid for transfer to son is:
 $(\$90,000/\$150,000) \times \$38,800 = \$23,280$

The basis increase for the son is:
 (net appreciation/amount of gift) X gift tax paid = basis increase
 $(\$33,000 /\$90,000) \times \$23,280 = \$8,536$

Son's basis in the real property is \$71,000 plus \$8,536 or \$79,536.

If the adjusted basis is more than the FMV of the gift:

- The basis for computing gain and depreciation is the adjusted basis of the property.
- The basis for computing loss is the FMV of the property.

Example Joe purchased shares of stock in XYZ Corporation at \$180 per share in 2001. This year, when the FMV was \$21.75 per share, Joe gave the shares to his son, Calvin, who hoped to take advantage of the resurgence of the industry. However, after careful consideration, Calvin decided to direct his portfolio in a different area by selling the stock. If Calvin sells the stock at \$12.35 per share; his basis for determining loss is \$21.75 per share. Therefore, he has a loss of \$9.40 per share.

Had Joe sold the stock and given the money to Calvin instead, Joe would have reported a loss of \$158.25 per share (\$180.00 basis minus \$21.75 selling price) and passed the cash to his son.

If using the donor's adjusted basis to compute gain results in a loss, and the FMV to determine loss results in a gain, there is no gain or loss upon the disposition of the property according to §1015(a).

Example Calvin was gifted stock that cost the donor \$180 per share but had a FMV of \$21.75 at the time of the gift. Since his basis is \$180 per share for gain purposes, but \$21.75 per share for loss, if the stock sold at a price between \$21.75 and \$180, Calvin would have no gain or loss to report.

If the sales price is \$100 per share, his basis for determining gain is \$180, which results in a loss ($\$100 - \$180 = \$80$). His basis for determining loss is \$21.75, which results in a gain ($\$100 - \$21.75 = \$78.25$). Therefore, no gain or loss is recognized.

Part Gift and Part Sale

Occasionally taxpayer's will transfer or sell property to children at a price substantially below cost or FMV. Such transactions can be construed as part gift and part sale.

The basis of property received in a transaction that is part gift and part sale is the sum of the following [Reg. §1.1015-4(a)].

- The greater of the amount paid for the property or the transferor's adjusted basis of the property at the time of the transfer.
- The amount of increase, if any, allowed due to the gift tax paid.

However, the adjusted basis for determining loss cannot exceed the FMV of the property at the time of the transfer [§1015(a); Reg. §1.1015-5(a)(1)].

Example Jerry decided to sell his mansion to his daughter, Lily. The mansion was worth \$1,000,000, but Lily could only afford to pay \$550,000.

Jerry's basis in the property was \$300,000 resulting in the following.

<u>Sale</u>	<u>Gift</u>	<u>Lily's Basis</u>
\$550,000	\$450,000	\$550,000 + gift tax, if any

If Jerry's basis in the property was \$750,000, the result is as follows.

<u>Sale</u>	<u>Gift</u>	<u>Lily's Basis</u>
\$550,000	\$450,000	\$750,000 + gift tax, if any

The depreciable basis of a gift is the donor's adjusted basis. The donee not only receives the gift, but also the depreciation method, class life, holding period and accumulated depreciation [Reg. §1.1223-1(b)]. Any improvements or additional cost associated with acquiring the gift are depreciated as if it were a new asset (§1016).

Example Melissa was gifted a rental condo her uncle had purchased on January 2, 1998. The property was depreciated under MACRS over 27.5 years. Her uncle paid \$85,000 for it and had \$40,060 of accumulated depreciation. Melissa's basis for depreciation is the \$85,000. The accumulated depreciation belongs to her as well. She continues depreciating the property where her uncle left off. If Melissa renovates the property, the cost is treated as an improvement with a new depreciable life.

If the donor's basis is greater than the sales price, the selling price becomes the basis resulting in no gain or loss. The remaining portion of the basis is allocated to the gift and reported on Form 709, *United States Gift (and Generation-Skipping Transfer) Tax Return*, if applicable.

Example If Howard transfers property to his son for \$30,000, and the property at the time of transfer had an adjusted basis in Howard's hands of \$60,000 and a FMV of \$90,000, the unadjusted basis of the property in the hands of the son is \$60,000.

Howard's basis allocated to the sale is \$30,000, resulting in no gain or loss. The remaining \$30,000 basis is allocated to the gift. Therefore, the son's basis is Howard's adjusted basis of \$60,000 (\$30,000 + \$30,000).

Life Interest and Remainder Interest

Very often parents will transfer title of their home to their children but retain a life interest or life estate for the balance of their lives.

In cases such as this, when the donor has the right to use and enjoy gifted property until death, the donor is said to retain a life estate. The person or persons to whom the property is gifted are said to own a remainder interest in the property. The donor's date of death, or the date the property is sold, is the reference point used to determine the basis of the life estate and the remainder interest.

Prior to the decedent's date of death, the basis of a life estate and remainder interest are calculated with reference to the uniform basis and the age of the donor. The uniform basis is the basis of the donor at the time of the gift [Reg. §1.1014-5(a)(3)]. The life estate and the remainder interest factors change with time. As the donor gets older, the remainder factor increases while the life estate factor decreases (life estate factor + remainder factor = 1).

Upon the decedent's death, the life estate ceases to exist; only the remainder interest exists. The basis of that interest is the FMV on the date of death because §2036 causes property with a pre-death life interest to be included in the decedent's estate. A modified carryover basis applies for a decedent's life estate in 2010 if elected by the executor.

Example Edward gifted his son land valued at \$125,000 at the time of the gift, but retained a life estate. Edward paid \$100,000 (uniform basis) for the property. When Edward died, the property was worth \$250,000.

If Edward and his son sold the life and remainder interests before Edward's death, the basis of \$100,000 is apportioned between the two individuals based on the factors found in Table S at the IRS website [also found in Reg. §1.642(c)-6(e)(6) and Reg. §20.2031-7(d)].

Since the property was not sold until after Edward's death, his son's basis is \$250,000, the FMV on the date of Edward's death.

Transfers Between Spouses

Any transfer of property between spouses during marriage, or any transfer of property between former spouses incident to divorce, is treated as a gift. Consequently, the recipient's basis in the property is the transferor's adjusted basis immediately before the transfer regardless of the fact that the basis may be less than, equal to, or greater than the property's FMV [§1041(b)].

There is no gain or loss recognized on transfers made incident to divorce that include payments of cash or other consideration in addition to receiving the property. Nor does the payment get added to the property's basis.

Example Sam and Mary are divorcing. Sam owns a lake lot with an adjusted basis of \$5,000 and FMV of \$25,000. To terminate the marriage, Sam transfers a lake lot to Mary in exchange for \$10,000. Neither Sam nor Mary recognizes gain or loss on the transfer and Mary's basis in the land is \$5,000 even though she paid Sam \$10,000.

The prior depreciation and holding period carryover to the receiving spouse, and recapture of depreciation is not required of the transferor spouse [§1245(b)(1) and §1250(d)(1)]. Recapture of depreciation is required when the transferee spouse disposes of the asset, even if the transferee spouse never received the benefit of prior claimed depreciation on the asset.

Like-kind Exchange

Like-kind exchanges (§1031) are a common way to defer gain recognition on business or investment property until a later time. Basically, a taxpayer trades one piece of business or investment property for another one of similar kind or use. An example of a very common business like-kind exchange is the trade-in of one vehicle for another.

Nonrecognition treatment for gain in a like-kind exchange is mandatory if all of the following conditions are met.

- An exchange or sale has occurred.
- The properties transferred and received are used in a trade or business or for investment purposes.
- The properties exchanged are like-kind or similar in use.

Generally the basis of like-kind property received is computed as follows:

	Adjusted basis of like-kind property given
+	FMV of money or other unlike property given (boot)
+	Gain recognized on like-kind property given
+	Expenses paid
-	Loss recognized
-	FMV of money or other unlike property received (boot)
=	Basis of like-kind property received

Example Sharon bought a vacant lot for \$100,000 and built an apartment building on it for \$1,000,000. The lot and building are now worth \$2,000,000. Her adjusted basis is \$764,000 in the building and \$100,000 in the lot. She exchanged the apartment building, plus \$500,000 cash, for a commercial office building worth \$2.5 million.

She meets the §1031 exchange requirements and recognizes no gain or loss. Sharon's basis in the replacement property is:

\$ 100,000	(basis in the old lot)
+ 764,000	(adjusted basis in the old building)
<u>+ 500,000</u>	(additional cash paid)
\$1,364,000	

When a loss is realized as a result of property other than like-kind property received in the exchange, no loss is recognized under §1031(c). The basis of the like-kind property received in the exchange is reduced by the boot received.

Example John relinquished land with a basis of \$45,000 and received land with a FMV of \$30,000 plus \$10,000 in cash. A loss of \$5,000 (\$40,000 - \$45,000) is realized, but not recognized. The basis of the new land John acquired is:

\$ 45,000	(basis in the old land)
<u>- (10,000)</u>	(cash received)
\$ 35,000	

The basis of unlike-kind property received in a like-kind exchange is the property's FMV [§1031(b)].

Example Alex exchanged a residential rental building with adjusted basis of \$100,000 and FMV of \$150,000 for a duplex worth \$140,000 and a car worth \$10,000.

Realized gain:

\$ 140,000	(FMV of duplex)
10,000	(FMV of car)
<u>(100,000)</u>	(adjusted basis of rental given up)
\$ 50,000	

Recognized gain: \$10,000 (boot received)

Basis in unlike-kind property is \$10,000 (FMV of car)

Basis in like-kind property is \$100,000 (adjusted basis in old, plus additional cash paid or unlike-kind property given up)

If more than one property to which the nonrecognition rules apply is received, the basis is allocated among those properties in proportion to their FMV on the date of the exchange [§1031(d)].

Example Paula owns two improved lots. Lot 213 has a FMV of \$25,000 and Lot 214 a FMV of \$40,000. She trades the two properties to Henry in exchange for improved Lot 215 worth \$65,000. Henry has a basis in Lot 215 of \$30,000. Paula and Henry meet the §1031 exchange requirements and neither party recognizes any gain or loss.

Henry's basis in his old Lot 215 is allocated between Lots 213 and 214 received in the exchange. The allocation is based on the respective FMV of each property on the date of the exchange.

Henry's basis in Lot 213 is \$11,538 ($\$25,000/\$65,000 \times \$30,000$).

His basis in Lot 214 is \$18,462 ($\$40,000/\$65,000 \times \$30,000$).

The holding period of property surrendered in a §1031 exchange carries over and tacks on to the holding period of the like-kind property received [§1223(1)]. Any boot received has a new holding period that starts on the date of exchange rather than a carryover holding period.

When like-kind exchanges occur between related parties and either party disposes of the property within two years of the exchange, the exchange fails as a like-kind exchange and the deferred gain or loss is reported on the taxpayers' tax returns in the year the later disposition occurs. The basis of the original property received is its FMV. These rules do not apply in the following circumstances.

- Dispositions due to the death of one of the parties.
- Dispositions due to an involuntary conversion.
- Dispositions where neither the original exchange or subsequent sale was involved with tax avoidance.

Involuntary Conversion

A property can be involuntarily converted as a result of destruction, theft, seizure, condemnation or threat of condemnation. The basis of the replacement property is calculated using the basis of the property given up as a starting point.

Replacement property received that is similar or related in service to the converted property assumes the old property's basis on the date of the conversion adjusted for the following.

Decrease basis for:

- Any loss recognized on the conversion.
- Any money received but not expended on the similar property.

Increase basis for:

- Any gain recognized on the conversion.
- Any costs incurred in acquiring the replacement property.

The receipt of insurance proceeds or condemnation awards will generate a realized gain or loss on the former property. When the proceeds are used completely to purchase similar-use replacement property and a gain is realized, its deferral or nonrecognition is mandatory per §1033(a)(1). The deferred gain reduces the cost basis of the replacement property to arrive at basis.

If multiple replacement properties are received, allocate the basis among the properties based on their respective costs.

Example Joshua received a condemnation award of \$325,000 from the city for his residential rental property. At the time the property was relinquished, his adjusted basis in the rental was \$250,000 of which \$100,000 was allocated to the land. Joshua's realized gain is:

\$ 325,000	condemnation proceeds received
(150,000)	adjusted basis in rental
<u>(100,000)</u>	basis in land
\$ 75,000	

Variation 1:

Joshua purchased a similar-use replacement property for \$350,000. His basis in the new property is:

\$ 350,000	purchase price
<u>(75,000)</u>	deferred gain
\$ 275,000	

Variation 2:

Joshua purchased a similar-use replacement property for \$300,000. Joshua has taxable income of \$25,000 (\$325,000 – \$300,000) for the portion of condemnation award that was not used for qualifying replacement property. His basis in the new property is:

\$ 300,000	purchase price
<u>(50,000)</u>	deferred gain
\$ 250,000	

Variation 3:

Joshua used only \$225,000 of the \$325,000 of proceeds on a similar-use replacement property. Joshua has taxable income of \$75,000. Even though Joshua didn't use \$100,000 of the condemnation proceeds, the maximum recognized gain is limited to the total realized gain upon conversion. His basis in the new property is:

\$ 225,000	purchase price
<u>(0)</u>	deferred gain
\$ 225,000	

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